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The impact of contracts on trust in entrepreneur-VC relationships.

Key words:

Contracts, control, trust, agency theory, venture capital, small business.

ABSTRACT

Venture capitalists (VCs) increasingly rely on elaborate formal contracts and incentivization through share ownership to manage their relationships with the entrepreneurial firms they invest in. This study analyzes the impact of a high degree of such “neoclassical contracting” on entrepreneurs’ trust in their VC backers. The results from a sample of 86 Dutch entrepreneurial firms indicate not only that a high degree of neoclassical contracting tends to erode entrepreneurs’ trust in their VCs, but also that the use of more informal, relational contracting fails to moderate the negative association between a strong focus on neoclassical contracts and trust. However, entrepreneurs do welcome some level of monitoring, which highlights the enduring tension between trust and control, and the need for VCs to strike a productive balance.

INTRODUCTION

According to a Gallup survey of European small and medium sized enterprises (SMEs) conducted in July 2009, access to finance remains a key challenge facing entrepreneurial firms. While only a few such firms have access to Venture Capitalist (hereafter VC) funding, these firms often achieve high levels of innovation and growth (European Commission 2009).

In VC-entrepreneurial relationships both parties need each other: the entrepreneur has a novel competitive opportunity and perhaps the technical understanding to realize its potential (Cable and Shane, 1997), while the VC brings risk capital, expertise in formulating

effective commercial strategies and access to valuable networks of customers, suppliers and other capital providers (Busenitz et al., 2004; Gorman and Shaman, 1989; MacMillan et al., 1989). A workable level of mutual cooperation between them is a necessary (though not sufficient) condition for the success of VC-backed firms (Cable and Shane, 1997).

Yet, as a forward exchange (i.e. a transaction in which returns are only generated and allocated sometime in the future: Hung, 2006), both parties face the prospect of being exploited by the other, as well as the possibility of a failed venture (Cable and Shane, 1997; De Clercq and Sapienza, 2001; Gorman and Shaman, 1989). Both are exposed to the threat of divergent objectives regarding decisions such as the valuation of stock, strategic goals, allocation of resources, risk management and exit timing (Busenitz et al., 1997; Wijbenga et al., 2007). In addition, neither party can enjoy complete knowledge about their partner's future intentions, and may doubt the other's general and specific competences. Both must nevertheless rely upon the specialist knowledge and resources brought to the table by the other. Just as VCs need to have confidence in the entrepreneur (De Clercq and Sapienza, 2006: 341; Hung, 2006; Harrison et al., 1997), so too must entrepreneurs have confidence in their VCs to realize the successful outcomes sought from the investment. Confident risk-taking for a mutually productive collaboration is the essence of positive VC-entrepreneur relationships (Sapienza and Korsgaard, 1996).

Confident risk-taking in turn requires trust. In definitional terms, trust is founded upon an evaluation of the focal party's ability, benevolence and integrity (Mayer et al., 1995) forming an overall assessment of their trustworthiness. Positive expectations across these dimensions inform a willingness to accept vulnerability in dealings with that party (Rousseau et al., 1998). This is demonstrated in risk-taking acts, such as increasing dependence on the trustee, sharing resources, and reduced monitoring of their actions (Dietz and den Hartog, 2006; McEvily et al., 2003).

Trust has been shown to play a crucial role in managing ambiguous relationships characterized by risk (Das and Teng, 1998), such as that between an entrepreneur and her VC backers. Research confirms that confident risk-taking by both entrepreneur and VC is essential for a mutually productive collaboration in venture capitalist backed enterprises (Sapienza and Korsgaard, 1996). Trust can impact positively on the attitudes and behaviors of participants to a project by encouraging and fostering collaboration, information sharing and creativity (De Clercq and Sapienza, 2005, 2006; Dirks and Ferrin, 2001). Yet trust has so far received limited attention within the entrepreneurship literature (for reviews see Welter and Smallbone, 2006; Hohmann and Welter, 2005).

The governance structures of entrepreneurial firms may be a decisive factor in securing this trust. Increasingly, VCs are placing importance on the use of strict, elaborate contracts for the control and monitoring of entrepreneurial firms (Van den Berghe and Levrau, 2002; Zahra et al., 2006). Such *neoclassical* contracts specify, *ex-ante*, detailed incentive, control and arbitration mechanisms. Many VCs perceive this type of contract as an effective substitute for more flexible, “relational” means of control, which emphasize more developmental means of coordinating relationships based on interpersonal communication and informal goodwill (Klein Woolthuis et al., 2005; Nooteboom et al., 1997).

While entrepreneurs might expect a certain degree of neoclassical contracting as a matter of course in any dealings with VC backers, such stringent contractual controls were primarily developed in the context of large listed companies with highly diversified minority investors. Elaborate neoclassical contracts may not transfer well to more cooperative relationships such as those between entrepreneurs and VCs. They might even have unintended consequences for the entrepreneur’s trust in the VC.

To date, the majority of the research on trust in entrepreneurial settings has focused on the perspective of the VC; the entrepreneurs’ perspective has been neglected. An

exception is the study by Busenitz et al. (1997). They analyzed a variety of conditions affecting new venture teams' (NVTs) perceptions of fairness in the relationship with their VC. They found that earn out arrangements, the team's industry experience and average tenure in the firm negatively framed NVTs' fairness perceptions, while the length of time the team had been working together was positively related. Interestingly, for the purposes of this study, the use of constraining covenants was found to be unrelated.

This study also takes the entrepreneurs' perspective. We test the impact of the degree to which two different types of control are employed on entrepreneurs' trust in their VC backers, with a sample collected in the Netherlands. We first locate our theorizing within agency theory, exploring how readily corporate governance mechanisms developed based on agency theoretical assumptions can be transferred to VC-entrepreneur relations. We then review the available studies on the impact of contracts and more relational forms of control on our dependent variable, the entrepreneur's perception of the trustworthiness of their VC. Next, we provide information about the study's method, and report the results. We conclude with a discussion of the implications of our findings.

THEORY

Agency theory and corporate governance: neoclassical contracts.

Agency theorists assert that, due to the separation of ownership and control, principals need to reduce the agents' interest in exploitative opportunistic behaviors. The principal (i.e. the VC investor) needs to reduce the information asymmetry presumed to be enjoyed by the agent (i.e. the entrepreneur) (Williamson, 1988), and align the agent's interests to his own (Ang et al., 2000) to avoid opportunism, such as the use of corporate resources for private purposes, the divestiture of valuable company assets to firms owned by the agent at below market prices (i.e. "tunneling"), excessive risk taking or shirking (Arthurs and Busenitz,

2003; Ang et al., 2000; Jensen and Meckling, 1976; Fama and Jensen, 1983a, 1983b). This is best achieved through binding *neoclassical contracting* and/or incentive mechanisms (see Fama and Jensen, 1983a, 1983b).

Neoclassical contracts establish and frame the relationship by delegating decision-making authority over some of the principal's assets to the agent; defining the boundaries of discretionary behavior for both principal and agent, and setting out the basic institutional structure for ongoing negotiations, incentives and sanctions regarding the pursuit of both parties' objectives (Fama and Jensen, 1983a; Jensen and Meckling, 1976; Levinthal 1988). Principal-agent theory proposes that such contracts reduce the principal's risk, thereby making investment relationships more efficient.

The possibility that emergent interpersonal experience (i.e. "relational" contracting) might help principals and agents to develop a better appreciation of each other's intrinsic motivations, attitudes and behavior patterns, and therefore to trust each other as people rather than as signatories to a legal contract – and that this form of governance might serve as effectively as highly detailed and formalized contracts, if not more so (Barney and Hansen, 1994) – is not even considered by agency theorists.

There are several reasons why a high degree of neoclassical contracting might negatively affect entrepreneurs' trust in VCs. Firstly, the entrepreneur is typically the much weaker party in such relationships. Jensen and Meckling's (1976) analysis assumes that both entrepreneurs and investors will be able to anticipate and value potential agency costs *ex-ante* reliably, and that entrepreneurs are able to choose principals who fit their preferences. Jensen and Meckling (1976) also expect entrepreneurs to be able to simply exit an unfavorable investment relationship at any time, and find a more favorable investor instead. In economies with liquid capital markets for SMEs, both the entrepreneur and the investor *are* provided with a choice of partners, which improves the balance of power not only during the initial

bargaining stage but in negotiations subsequent to the investment. Research by Graebner (2009) confirms that VCs operating in liquid capital markets (e.g. the USA) are acutely aware that their behavior towards entrepreneurial firms shapes their reputation, and thereby their ability to engage in future acquisitions successfully. However, in most economies, capital markets for small businesses tend to be characterized by poor efficiency and liquidity (Lawton, 2002; Boocock and Woods, 1997). The distinct lack of a primary, let alone a replacement, market for each party involved (Cable and Shane, 1997) means that “hold-up problems” may occur, effectively allowing one party to hold the other hostage. In practice, the advantage here is firmly with the VC (Landström et al., 1998).

Secondly, many of the typical rights and obligations enshrined in neoclassical contracts are one-sided in favor of the investor, including board member voting rules; veto rights over important decisions; investors’ rights of inspection of accounting and legal books; anti-dilution terms; limits to managerial salaries; conditions for replacing incumbent managers; even the right to dismiss the entrepreneur (Busenitz et al., 1997; Mason and Stark, 2004). Once these constraining conditions are approved by the parties, entrepreneurs have little chance to reconsider or modify them, and hence may develop negative perceptions of fairness and goodwill in the relationship (Busenitz et al., 1997). All of these conditions may work to constrain opportunism and lessen the principal’s risk, but they do little to invite, or nurture, the entrepreneur’s trust.

Thirdly, and related, experienced VCs generally have much greater expertise or access to powerful legal counsel when negotiating a contract (see Landström et al., 1998; Busenitz et al., 1997; Mason and Stark, 2004). While in theory entrepreneurs can safeguard themselves by hiring good legal representatives, research indicates a tendency for entrepreneurial firm representatives to focus on informal, trust-based agreements rather than formal contracts (Graebner, 2009). The power asymmetry created by elaborate contracts is

likely to increase the principal's temptation to exploit the weaker partner (Komorita and Parks, 1995). If the entrepreneur is aware of this temptation, it may further erode their trust in their VC.

Strict contractual arrangements aimed at preventing opportunistic behavior may *discourage* co-operative behavior (Poppo and Zenger, 2002; Sapienza and Korsgaard, 1996). Agents may become less inclined to be personally involved with the principal and to fully disclose the venture's details, anticipating punishment from the principal should things go wrong. Entrepreneurs' reluctance to seek help and advice from VCs for fear of making themselves vulnerable to sanctions is likely to impact on the economic success of the venture.

Additionally, contracts that cover many contingencies with respect to well-specified rights and duties and strictly quantifiable performance targets can be overly complex, denying flexibility to the parties (Busenitz et al., 1997; Landström et al., 1998; Jap, 2001). Emphasis on the decision control function can lead to rigidity in the entrepreneurial firm's decision making process, impeding the agent's capacity to make quick changes to the firm's strategy and operations, or exploit innovations. This is likely to cause further frustration for the agent with the principal (Busenitz et al., 1997).

The concomitant neglect by agency theory of the possibility of positive interpersonal reciprocity is especially problematic for entrepreneurial firms, as the success of such firms relies upon active cooperation between entrepreneurs and VCs (Cable and Shane, 1997). Also, firm founders tend to display very high degrees of intrinsic motivation, which might be eroded if outside investors increase their influence over the company's management and limit the founder's discretion (Boocock and Woods, 1997; Wasserman, 2006; Arthurs and Busenitz, 2003).

Agency theory and corporate governance: incentivization through share ownership.

Agency theory's other recommendation is to incentivize the agent to act appropriately on the principal's behalf through managerial share ownership, as both parties' wealth and income will increase if the firm prospers (Holderness, 2003; Gompers and Lerner, 2000: 131; Fama and Jensen, 1983a; 1983b). Applied to VC-entrepreneur relations, investors seek to align the interests of the entrepreneurs with their own by requiring entrepreneurs to maintain significant investments in the venture. This shared destiny is expected to increase mutual trust in the relationship.

However, contractual features such as ownership stake requirements, executive payment in share options and high leverage ratios increase the risk and costs of bankruptcy for the entrepreneur (Barnes et al., 1996; Ang et al., 2000). VCs can benefit from sharing the risk with other investors, and from general risk reduction through investment diversification, but entrepreneurs usually risk all or most of their assets in one venture (Fama and Jensen, 1983b). Moreover, while VCs can usually spread their investment uncertainty across multiple rounds of investment (Wasserman, 2006), entrepreneurs often have to commit to their investment from the outset. This strengthens further the VC's powerful position since their sunk costs are comparatively lower than those of the entrepreneur. Entrepreneurs might therefore interpret elaborate neoclassical contracts that require them to maintain a high stake in the company, and accept shares or share options as a significant part of their remuneration, as an indication of the VC's mistrust.

Finally, Arthurs and Busenitz (2003) suggest that, taking into consideration the non-financial investments of time, energy and sweat equity made by the entrepreneur, it is likely that entrepreneurs see their "ownership" as something greater than merely financial ownership. Share-based incentivization may be counterproductive, as it deflates the agent's

intrinsic motivation (and psychological ownership) and limits their scope to maneuver (Wassermann, 2006).

Relational contracting.

While neoclassical contract theory assumes that contractual relationships can be modeled as discrete transactions, without taking into account social and personal contexts, and can best be governed by elaborate and specific contracts, relational contract theory highlights the importance of more informal arrangements (Macneil, 1981). These are far less specific and allow far more room for the development of collaborative relationships based on ongoing communication and negotiation. Relational contracting tends to focus on aspects of the ongoing relationship itself, and these may depend on the extent to which shared values and parties' expectations about future interactions have been established, independent of any binding contract between the parties (Macneil, 1981; Heide, 1994). Relational "controls" extend significant autonomy to the agent by minimizing *a priori* constraints, thereby enhancing the agent's intrinsic motivation to perform effectively in pursuit of the success of the entrepreneurial firm (Wassermann, 2006). Additionally, if contracts are softened, it should become easier for entrepreneurs to respond, with the VC's consent, to changes in the business environment (see Poppo and Zenger, 2002).

However, as relational contracts are less specific and often based on informal agreements, they are more difficult to enforce and provide contractual partners with less protection from exploitation by opportunistic behavior. Graebner's (2009) research on the acquisition of entrepreneurial firms suggests that the inability to enforce relational contracts might lead investors to disregard them as non-binding, and just mere words extended as part of social interactions with entrepreneurs. Yet many entrepreneurs place great emphasis on the (non-contractual) 'word' – informal commitments, verbal promises – of their investors.

In practice, of course, contractual relationships tend to be neither wholly neoclassical nor relational but located along a continuum between the two extreme positions of formal, fairly anonymous, comprehensive and specific neoclassical contracts and informal, trust-based, continuously developing relational contracts. Increasingly, however, venture capitalists tend to favor the former type of arrangements.

The potential for the increased focus on neoclassical contracts, as advocated by agency theory, to damage entrepreneurs' confidence in VCs, and the relative merits of relational contracting as an alternative, also seem to be supported by research into the effects of different forms of control on trust.

Trust and different forms of contract.

The debate on the effects of different forms of control on trust posits two main perspectives: substitution and complementarity (see Costa and Bijlsma-Frankema, 2007).

The substitution thesis holds that trust and control are alternative approaches for managing a relationship (Malhotra and Murnighan, 2002). The more trust there is in a relationship, the fewer formal controls are necessary; conversely, the less trust there is, the more controls are needed to compensate (Gulati, 1995). In this condition the presence of any contract is based on assumptions of suspicion and the sanctions enshrined in the contract are presumed to obviate the need for "trust" – similar to agency theory assumptions. Alternatively, contracts ensure a form of "trust" based on deterrence, although this ought not to be considered "real" trust in the sense of positive expectations (Rousseau et al., 1998: 399). Thus, while VCs may use neoclassical contracts to safeguard their interests, entrepreneurs might view them as a signal of the VCs' lack of confidence in them, and this may stifle attempts at fruitful collaboration.

However compelling this substitution effect may seem in theory, there is no consistent empirical evidence for it (Costa and Bijlsma-Frankema, 2007; Klein Woolthuis et al., 2005: 817). The complementarity thesis tends to be more favored theoretically and found to be more prevalent empirically. This depicts trust and control as separate but co-existing, and even mutually reinforcing, means for arriving at a stable order of relations. In this perspective, one party may feel able to trust the other *because of* the existence of a formal contract, while two parties who trust each other may wish to confirm and cement their relational trust through joint commitment to a contract, much like formal marriage vows (Klein Woolthuis et al., 2005). This thesis suggests that agency theoretical recommendations regarding neoclassical contracts might have a positive impact on entrepreneurs' trust in VCs.

Yet the imposition of controls is widely assumed to be antagonistic to strong trust (Nooteboom et al., 1997: 318), and can have a “pernicious effect” on cooperation (Poppo and Zenger, 2002: 711). Malhotra and Murnighan (2002: 547) found that contracts may elicit modest levels of cooperation, but their introduction also “impeded the development of trust” and “diminished existing trust”. This is likely to be especially true for parties seeking to retain independence and control of their own fate, such as entrepreneurs.

Das and Teng (1998, 2001) argue that “social” and normative controls (in our terminology, “relational contracting”) are more likely to improve understanding and accommodate flexibility, and hence enhance trust. The entrepreneur may interpret this autonomy as indicative of the VC's benevolence. By contrast, formal controls (e.g. a “neoclassical contract”) may deny parties autonomy to act and undermine impressions of the other's self-governed goodwill, as well as generating tensions that compromise the partners' competence.

Thus, considering the available studies on trust and control, the increased use of neoclassical contracting looks likely to have a negative effect on fostering entrepreneurs'

trust in their VC, while “relational” contracting may prove more effective. (Of course, without a minimum level of trust, no contract can work: see Das and Teng, 2001: 265.)

HYPOTHESES

Based on our review of the literature we developed the following model (Figure 1), and associated hypotheses.

INSERT FIGURE 1 ABOUT HERE.

In situations characterized by efficient markets, neoclassical contracting is expected to benefit both the principal and the agent and lead to the efficient allocation of rights and obligations between both (Levinthal 1988). In this case, neoclassical contracting might be seen by the VC as a substitute for the need to develop trust: the substitution thesis. This points to a negative relationship between trust and neoclassical contracting. Alternatively, the complementarity thesis suggests that neoclassical contracting might provide both principals and agents with a basis for the development of trust, thereby suggesting a positive association between trust and neoclassical contracting. As we argued above, VC-entrepreneur relationships in most countries are not conducted in the context of efficient markets. Therefore, neoclassical contracting tends to cement the asymmetric distribution of power between the VC and the entrepreneur which exists due to the lack of transparency and liquidity of the relevant capital markets (Cable and Shane, 1997) and the greater legal expertise of VCs in drawing up contracts. In sum, we do not expect neoclassical contracts to have a benign effect on trust. This leads us to our first hypothesis:

Hypothesis 1: There is a negative association between the use of elaborate neoclassical contracts and the entrepreneur's trust in the VC.

Agency theory suggests that managerial part-ownership of the venture should lead to a reduction of friction between entrepreneurs and their outside investors and ought therefore to be positively associated with trust. However, as previously discussed, entrepreneurs who own high ownership stakes in their business might perceive a high degree of neoclassical contracting as an unwelcome threat. This is due to the increased risks such a contractual arrangement can entail for them and their relative vulnerability vis-à-vis their VC backer (i.e. entrepreneurs typically having to invest up-front and to risk all or most of their assets in the one venture, coupled with VCs' capacity to invest across multiple investment rounds and diversify their investment risks across multiple ventures). Additionally, the imposition of greater share ownership requirements alongside a neo-classical contract may seem, in the entrepreneurs' eyes, to down-grade or belittle their intrinsic, non-financial, motivations. We thus predict that incentivization through share ownership will *not* ameliorate relations governed by neoclassical contracts, but will exacerbate the potential for mistrust manifest in the neo-classical contract. In sum, greater share ownership is expected to impact negatively on entrepreneurs' perception of VCs' trustworthiness when relations are governed by neoclassical contracts:

Hypothesis 2: The agent's share of ownership moderates the negative association between the use of elaborate neoclassical contracts and the trust of the entrepreneur in the VC such that this negative association will be stronger when the entrepreneur has a greater share ownership in the venture.

In contrast to neoclassical contracts, relational contracting is based on more informal arrangements in which agents have significant autonomy and ongoing communication and negotiations play key roles for the development of collaborative partnerships. We have seen how relational contracting relies on a high degree of communication and negotiation, and this allows the contracting partners to get to know each other, helping them to develop, first-hand,

clear expectations about each other's trustworthiness: a form of "goodwill trust" (cf. Das and Teng, 2001). This suggests that the use of more informal, "relational" arrangements should prove more conducive to the entrepreneur's perceptions of the trustworthiness of the VC. Thus:

Hypothesis 3: There is a positive association between the use of relational contracts and the entrepreneur's trust in the VC.

The complementarity thesis suggests that trust and control are mutually reinforcing because the contracting parties may feel able to trust the other due to the existence of enforceable neoclassical contracts limiting the risk of exploitation. Yet the concerns of entrepreneurs about the trustworthiness of VCs who safeguard their own rights by employing a high degree of neoclassical contracting might be reduced if these strict contracts are complemented by a high degree of relational contracting. Indeed, the complementarity thesis implies that two parties who trust each other may wish to *affirm* their relational trust by signing up to a binding neoclassical contract. We might therefore expect any negative influence from a high degree of neoclassical contracting on perceptions of VCs' trustworthiness to be moderated (i.e. weakened) by a concurrent high degree of relational contracting.

Conversely, it could be argued that entrepreneurs whose relationship with their VC is characterized by strong relational contracting might perceive the parallel existence of an elaborate neoclassical contract as an indication of their VC's lack of trustworthiness (i.e. a contradictory signal of intentions), or as a potential threat because the VC could use the legally enforceable neoclassical contract to challenge any informal relational commitments. In this case, neoclassical contracting would be expected to moderate (i.e. weaken) the positive association between the use of relational contracts and the entrepreneur's trust in the VC.

Since neoclassical contracts tend to be designed *ex-ante*, while relational contracting develops *ex-post*, we expect the former relationship to be more likely than the latter. Thus:

Hypothesis 4: The use of relational contracting moderates the negative association between the use of elaborate neoclassical contracts and the entrepreneur's trust in the VC, such that this association will be weaker when relational contracts are also used.

METHOD

Data

A questionnaire was sent to the whole population of venture capital-backed companies in the Netherlands in 2003, sourced from the dataset of the Dutch Chambers of Commerce, as well as from annual reports and Internet sites of VCs operating in the Netherlands. Of the 611 companies that received VC funding that year, 86 useable questionnaires were returned after two mailing rounds. Kolmogorov-Smirnov (K-S) tests indicate that there are no significant differences between early and late respondents for any of the variables. This response rate of 14% is comparable to the typical rate of 10-12% for studies targeting Chief Executives (Schulze et al., 2001), and small businesses (De Kok and Uhlaner, 2001). Cochran's (1977) formula for sample size requirement shows that a sample of more than 61 firms is sufficient to make generalizations about a relatively small population of 611 firms, with a 4% margin of error for 7-point Likert scales.

Dependent variable

The proxy for the dependent variable, *trust*, is based on Kumar et al.'s (1995) measure. Strictly speaking, this is a measure of perceived trustworthiness (see Dietz and den Hartog, 2006), expectations of which form the basis of the actual decision to trust. However, the

entrepreneurs surveyed are clearly exhibiting risk taking behavior associated with their perceptions of their VC's trustworthiness.

Kumar's scale encompasses two sub-dimensions. The first is trust in the partner's integrity: the belief that the partner will stand by their word, fulfill promised obligations, and be sincere. The second is trust in the partner's benevolence: the belief that the partner is committed to the firm's welfare and will not take deliberate actions that might damage the firm's prospects. Trust exists, therefore, when the agent (entrepreneur) expects the principal (VC backer) to display these two characteristics. (The VC's "ability" is captured in the "VC – added value" scales.) The items were ranged on a Likert scale where 1 = "Totally disagree" and 7 = "Totally agree".

Factor analysis showed that perceptions of "integrity" and "benevolence" could not be separated. All items showed high factor loadings on a single factor, except the items "The VC has often provided us information that has later proven to be inaccurate" (reverse coded) and "When we share our problems with the VC, we know that he/she will respond with understanding". We removed these items. The resulting factor analysis shows a unidimensional measure of trust, explaining 60.87% of the variance with factor loadings ranging from 0.47 to 0.86 (see Table 1a). The Cronbach α for the trust scale is 0.90.

[INSERT TABLE 1A ABOUT HERE]

Explanatory variables

In line with Macneil's (1981, 2000) argument that contracts are located along a spectrum from neoclassical contracts to relational contracts, VCs tend to use both types of contracting to varying degrees to manage relationships with entrepreneurs. To capture this in our design, we adapted Lusch and Brown's (1996) behavioral-based contracting measures to the VC-entrepreneurial firm setting. Lusch and Brown derived their measures' construct validity from

Heide (1994), who identified six key elements used to maintain interorganizational relations: role specification, planning, adjustment processes, monitoring procedures, means of enforcement and incentive systems. Lusch and Brown's (1996) measures match with the key elements of role specification, planning, adjustment processes and means of enforcement. The two missing elements are covered by our survey instrument as follows: "Monitoring procedures" relates to the use of systems that measure output and behavior, which is reflected in our "VC value-added - monitoring" measure. "Incentive systems" refer to the types of incentives used and the basis on which they are distributed. The share of ownership possessed by the entrepreneur can be regarded as a proxy for an incentive system. The items for both types of contracts were ranged on a 1-7 Likert scale (1 = "Totally disagree" and 7 = "Totally agree"). Factor analysis aimed at determining the scales' unidimensionality and discriminant validity further helped to refine the scales (see Table 1b).¹

The *neoclassical contracting* measure refers to the degree to which each party's roles, responsibilities, performance obligations and the handling of unexpected events are precisely defined in a written contract. The measure therefore focuses on specific behaviors, rather than on counting the number of sentences, pages or clauses in the contract. Cronbach α is 0.88. The *relational contracting* measure refers to the degree to which there is mutual understanding regarding each party's roles and responsibilities, and how each party is to perform. Cronbach α is 0.92.

[INSERT TABLE 1B ABOUT HERE]

Control variables

Since trust is based not only on the perception of a partner's benevolence and integrity but also competence (Mayer et al., 1995) and since VCs do not only contribute to the venture by providing risk capital but also engage in additional "value adding activities" (Wijbenga et al., 2007), it is essential to control for whether such additional services provided by the VC

affect the entrepreneurs' perception of their trustworthiness. In the venture capital literature the value-adding activities of VCs tend to be differentiated into "added value through networking" and "added value through monitoring".

In the first case, VCs support the venture by introducing the entrepreneurs to social and professional networks to improve their access to potential clients, distributors, investors, advisors, regulatory agencies, as well as tangible resources (Hillman and Daziel, 2003; MacMillan et al., 1989; Sapienza and Timmons, 1989). The degree to which such access to networks is facilitated by VCs not only demonstrates their competence as venture capitalists but also their level of cooperation with the entrepreneur.

VCs may additionally seek to improve the performance of the entrepreneurial firm through close supervision of the business, drawing upon their presumed expertise in key strategic domains (Wijbenga et al., 2007). On the one hand, such monitoring may be interpreted by the entrepreneur as indicative of concern for the venture's success (i.e. benevolence), and a sign of competence by helping the entrepreneur to be more effective (Flynn, 2001; Bijlsma-Frankema and Van de Bunt, 2003). Frequent communication and timely information sharing may also help to resolve disputes and align perceptions and expectations (see Busenitz et al., 1997). On the other hand, such efforts may be perceived as indicative of the VC's lack of trust in, and even respect for, the entrepreneur. This may prove corrosive of the reciprocated trust shown by the entrepreneur in the VC.

In the "*VC value-added – networking*" and "*VC value-added – monitoring*" scales, the entrepreneurs were asked to indicate the extent to which they agreed or disagreed that their VC had displayed these behaviors on a Likert scale from 1-7 ("Totally disagree" to "Totally agree"). Both types of value-adding activities can be distinguished and separated in the factor analysis (see Table 1c). The factor loadings for the items of both scales are higher

than 0.7. The Cronbach α for “VC value-added – networking” is 0.81; the Cronbach α for “VC value-added – monitoring” is 0.85.

[INSERT TABLE 1C ABOUT HERE]

We included formal relationship tenure as a covariate in the analysis. The duration of the relationship might impact on the entrepreneur’s trust in the VC, because of the presumption of an accumulation of positive or negative evidence over time of the VC’s conduct and attitudes (Sapienza and Gupta, 1994), and the effects of regular direct communication over time. The measure was taken from the date the company-level contract between the principal and agent was signed.

While the sample size limits our ability to include a large range of industry controls in our model, we employ the dummy variable “ICT/Life sciences” as a covariate, to indicate whether the entrepreneurial firm competes in an emergent industry or not. Emergent industries are generally characterized by high levels of uncertainty, which may make each party more vulnerable to opportunistic behavior from the other (Das and Teng, 2001). However, the dummy not only controls for an increased perception of entrepreneurs in emergent industries to be at risk of exploitation, but also for potential industry typical norms regarding the degree and content of “normal” neoclassical contracting in the high-tech industry. Lockett et al. (2002) highlight that the newness and complexity of the products, markets and technology in the high-tech industry pose particular challenges to VC firms, which have responded to these problems by developing specific due diligence, screening and monitoring practices.

As smaller firms may be expected to enjoy less power in the relationship with their VC, we included a proxy for *firm size*, which is the natural logarithm of the number of employees. We did this logarithmic transformation in order to account for the wide disparity in the number of employees among the set of firms.

Poor performance of the venture might induce VCs to increase the use of neoclassical contracting in order to increase their level of control over the entrepreneur and strengthen performance incentives. Alternatively, VCs might already have neoclassical contracts in place which allow them to increase their influence over the venture and potentially reduce the ownership rights of the entrepreneur when firms perform poorly (Van den Berghe and Levrau, 2002). In either case, the increased control rights of the VC might create more tensions in the relationship, and erode the entrepreneur's trust in the VC. We therefore test whether the relationships between contracting types and the entrepreneur's trust in the VC are driven by *firm performance* with two measures, sales and employee growth.

Common method variance

Since the study is based upon a single-respondent survey, we followed Podsakoff et al.'s (2003) recommended strategies for reducing common method bias. We ensured that we used scales with overtly different items, guaranteed respondents' anonymity, and the questions for the dependent variable (i.e. trust) preceded the questions for the independent variables (i.e. the contracting scales) in the questionnaire. We also conducted a Harman's single-factor test (Podsakoff et al., 2003). A factor analysis conducted with the items in the trust measure, the neoclassical and relational contracting measures, and a factor analysis with the items of the trust measure, VC monitoring and networking measures provide evidence that the analysis of the hypotheses does not appear to suffer from common method bias. The items of the contracting measures did not load highly on the factor which identified our trust measure.

RESULTS

Table 2 shows the descriptive statistics and correlations among the variables. As expected, there is a significant and positive association between the entrepreneur's trust in the VC and relational contracting ($r = .56$, $p < .01$). There is no significant association between

neoclassical contracting and the entrepreneur's trust in the VC. We also find a significant and positive association between the entrepreneur's trust in the VC and with the VC's added value in monitoring ($r = .48$, $p < .01$) and networking ($r = .35$, $p < .01$).

[INSERT TABLE 2 ABOUT HERE]

The significant and negative association between ICT/life sciences and the entrepreneur's trust in the VC ($r = -.29$, $p < .05$) suggests that entrepreneurs in these more volatile industries (compared to manufacturing and services) may feel more vulnerable to exploitation, and therefore perceive a higher risk that their VC will behave opportunistically. There is no significant correlation between ICT/life sciences and either neoclassical or relational contracting, which suggests that the degree of neoclassical and relational contracting in the high-tech industry does not differ from that in other industries.

Table 3 presents the OLS-regression analysis (Model 1) of hypotheses 1 and 3. Table 4 presents the moderated OLS-regression analysis of hypothesis 2 (Model 2) and hypothesis 4 (Model 3). For the analysis, the interaction term variables were zero-centered before their crossproduct terms were calculated to produce a meaningful interpretation of the main effects of the interaction terms, and to reduce multicollinearity (Jaccard and Turrisi, 2003: 24). To further avoid problems with multicollinearity we tested the interaction terms for hypothesis 2 and 4 in two separate models. Diagnostics indicate no multicollinearity problems for these three models, as tolerance levels are well above .55 (and hence VIF values well below 1.82) and condition indexes are below 11.19.

[INSERT TABLE 3 ABOUT HERE]

Hypothesis 1 is supported. Model 1 (Table 3) shows that there is a negative association between the use of neoclassical contracts and the entrepreneur's trust in the VC ($\beta = -.22$; $p < .05$). This suggests that entrepreneurs who are controlled by their VCs using detailed, highly specific, comprehensive written contracts, perceive their VC backers as less

trustworthy than entrepreneurs whose relationship with their VCs is based on a lesser degree of neoclassical contracting.

[INSERT TABLE 4 ABOUT HERE]

Hypothesis 2 is supported. Model 2 (Table 4) shows that a higher degree of share ownership on the part of the entrepreneurs *worsens* relationships governed by neoclassical contracts ($\beta = -.18$; $p < .05$). This suggests that entrepreneurs with a large stake in the firm feel more vulnerable against the wide range of contractual rights which reside with VCs. The difference value of the ΔR^2 of the “main effects only” model and the model with the interaction term is 0.03 ($\Delta F: 4.40$; $p < 0.05$), which is a typical value for field study interactions in the social science literature (Champoux and Peters 1987; Chaplin 1991; McClelland and Judd 1993). However, such a comparison index may be positively biased by our relatively small sample size (see Jaccard and Turrisi, 2003: 29). The standardized effect size statistic with a value of 0.08 suggests that the effect size of the interaction is relatively weak (> 0.02 is weak, while > 0.15 is a medium effect, and > 0.35 is a strong effect). The interaction effect is graphically illustrated in Figure 2.

[INSERT FIGURE 2 ABOUT HERE]

Hypothesis 3 is supported. As reported in Model 1 (Table 3), there is a positive association between the use of relational contracts and the entrepreneur’s impressions of the VC as trustworthy ($\beta = .46$; $p < .01$).

However, hypothesis 4 is not supported (Table 4, Model 3). Relational contracting does not seem to ameliorate relationships governed by elaborate neoclassical contracts, and neoclassical contracting similarly does not seem to enhance or damage relational contracting.

Table 3 (Model 1) shows that the relationship between VC added value in networking and the entrepreneur’s trust in the VC is not significant, suggesting that this effort by VCs may go unnoticed and unappreciated, at least in terms of trust development. However, there

is a positive relationship between VC added value from monitoring and the entrepreneur's trust in the VC (Table 3, Model 1: $\beta = .25$; $p < .05$). This suggests that the information revealed by monitoring may lead to the VC's better understanding of the entrepreneur's situation, enabling the VC to give more effective support, and this may lead the entrepreneur to perceive the VC as more trustworthy (i.e. competent and benevolent).

Finally, we tested whether the relationships between contracting types and entrepreneurs' trust in VCs are driven by firms' performance, using sales and employee growth over the past three years for the 65 companies for which we had performance data. The correlations between sales growth and the trust measure ($r = -.01$; $p < .96$), neoclassical contract ($r = .02$; $p < .90$) and relational contracting ($r = .09$; $p < .48$) were all insignificant, as were those between employees' growth and trust ($r = -.18$; $p < .15$), neoclassical contracts ($r = .07$; $p < .59$) and relational contracting ($r = -.01$; $p < .97$). These results suggest that there is no correlation between firm performance and the degree of neoclassical or relational contracting. Moreover, there is no correlation between firm performance and entrepreneurial trust in the VC. There were no changes to our results when we added the performance measures as covariates to the regression equations.

DISCUSSION

Previous research suggests that trust can impact positively on the attitudes and behaviors of participants to a project, and is a vital element of VC-entrepreneur relations (Sapienza and Korsgaard, 1996). The perception of VCs' trustworthiness, both in terms of their competence and integrity, is likely to affect entrepreneurs' decisions to seek VC investors to facilitate innovation in and growth of companies and the degree to which entrepreneurs in VC backed firms draw on VCs' expertise and advice. This paper has examined, from the perspective of

the entrepreneur, the tension between trust and control in the management of VC-entrepreneur relationships. Our findings point to several concerns.

The increasing focus of VCs on the use of neoclassical contracting might have unintended negative consequences. We found such contracts to be negatively related with the entrepreneur's perception of their VC's trustworthiness. This impression appears to get worse, rather than better, when a high degree of neoclassical contracting is combined with a high share of ownership by the entrepreneur in the firm. By contrast, our theorizing and our empirical findings suggest that relational contracting is more effective in facilitating positive entrepreneur perceptions of their VC's trustworthiness. These findings affirm what is becoming an established pattern of results in the trust literature on the effects of different forms of control. Yet the failure of relational contracting to reduce the negative impact of strict neoclassical contracting on entrepreneurs' trust in VCs, and the finding that positive perceptions of VC trustworthiness developed in a context of relational contracting are not damaged by neoclassical contracting, point to complex interaction effects worthy of future research.

Principal-agent theory argues that a degree of control is clearly essential, in order to avoid exploitation in relationships characterized by asymmetric information and potentially divergent interests. We do not disagree. Indeed, our findings on the positive relationship between "VC value-added via monitoring" and the entrepreneurs' trust in VCs do suggest that a certain degree of monitoring activity *is* perceived to be benign, and indicative of the VC's expertise and trustworthiness – a possibility previously raised by Bijlsma-Frankema and van de Bunt (2003). This particular finding is especially interesting from a trust development perspective, since much of that literature assumes that in trusting relationships the need for monitoring the other party should reduce.

Our findings suggest, therefore, that controls are not the issue; the problems lie with the forms, and intensity, of the controls. While we investigated the degree of neoclassical contracting and relational contracting, further research might investigate the impact of differences in the content of such contracts. Das and Teng (1998, 2001) suggest that the potential degree of complementarity depends on the type of control used (behavioral, output, social). Poppo and Zenger (2002: 731) propose that the precise terms included in a detailed contract may influence cooperation levels between parties, and contracts that provide “frameworks for *bilateral adjustments* may facilitate the evolution of highly cooperative exchange relations” (emphasis added). This should be explored in future research.

What is expected by entrepreneurs as a “normal” level of neoclassical contracting is likely to depend at least to a certain degree on the industry their firm operates within, as well as the firm’s size, the investment volume and the type of venture capitalist. It would also be interesting to see whether these findings are replicated in different national cultural and institutional settings. Dutch culture is individualistic but with a strong normative value of consensus-building (Hofstede, 1980), and legal contracts are understood to be enforceable in the Netherlands.² The differential effects of these variables could be explored in future research.

With regard to the development of governance systems, this research underlines the importance of paying close attention not only to the specific incentive structures of principals and agents but also to the power structures and social norms in their relationship (Macneil, 1981). It is crucial to take account of the potential for exploitation of *either* side. In VC-backed firms, a tight focus on control-oriented corporate governance mechanisms could crowd out other important functions of the board, such as the provision of specialist advice, business contacts and the support of strategy development (see Sundaramurthy and Lewis,

2003; Hillman and Daziel, 2003), which are emphasized in resource dependency theory but largely neglected by principal-agent theoretical approaches to corporate governance.

While the fact that we did not find a clear relationship between firm performance and VC-entrepreneurial trust relationships might be related to our use of growth rather than profit performance data, and that our data are concurrent rather than lagged, it nevertheless raises questions about the complex relationship between trust and performance. While trust is expected to increase both parties' willingness and ability to take potentially productive risks, trust might also allow entrepreneurs to engage in shirking. For future research this raises questions about whether the instruments used to measure trustworthiness and VC engagement need to be modified to be able to differentiate more clearly between different forms of trust (perceptions) and how they affect entrepreneurial behavior (e.g. via self-commitment, opportunistic behavior, etc.). Dirks and Ferrin (2001) argue for trust as a moderator of other independent variables' impact on performance; this could be modeled in future studies.

Our research investigates trust perceptions within existing VC-entrepreneur relationships. It would be interesting for future research to explore whether pre-existing trust between the VC and the entrepreneur affects the set-up and implementation of contractual relationships via longitudinal, qualitative and dyadic studies.

In conclusion, a workable degree of trust is essential for entrepreneurial ventures, and clearly *a* contract must be in place. However, this study raises concerns about VCs' increasing preferences for neoclassical forms of contracting, as they can have unintended negative effects on the trust of the entrepreneur in the VC which, in turn, could impact on the venture's performance as it might inhibit mutually beneficial cooperation between the entrepreneur and the VC (Poppo and Zenger, 2002; Sapienza and Korsgaard, 1996).

Endnotes

¹ Lusch and Brown's original items capturing "mutual understanding about legal remedies for failure to perform" and "mutual understanding about what happens in the case of events occurring that were not planned" did not load on the same factor as the other items associated with relational contracting. They each loaded high on a different, separate factor and were therefore removed from our scale. An explanation may be that, given the relatively short-term nature of the VC–entrepreneur relationship (usually 5-7 years), a number of firms in our sample may not have had the need or the chance to make adjustments to unexpected events, as major disagreements or a failure to perform may not have happened yet. Another explanation may lie in the disproportionate power in the relationship in favor of the VC: as we argued above, when unexpected events happen, VCs are likely to be better protected against downside risks than the entrepreneurial firm.

² Research by Welter et al. (2004) suggests that entrepreneurs in countries with weaker legal systems, where formal contracts are difficult to enforce, tend to rely on personal relationships and trust to acquire resources and exploit business opportunities. This suggests a substitutive relationship between trust and formal controls. However, their research further suggests that in countries with strong institutional structures, "personal trust mainly seems to play a complementary and second-best role" (Welter et al., 2004: 328).

TABLES AND FIGURES

FIGURE 1. The conceptual model, and hypotheses.

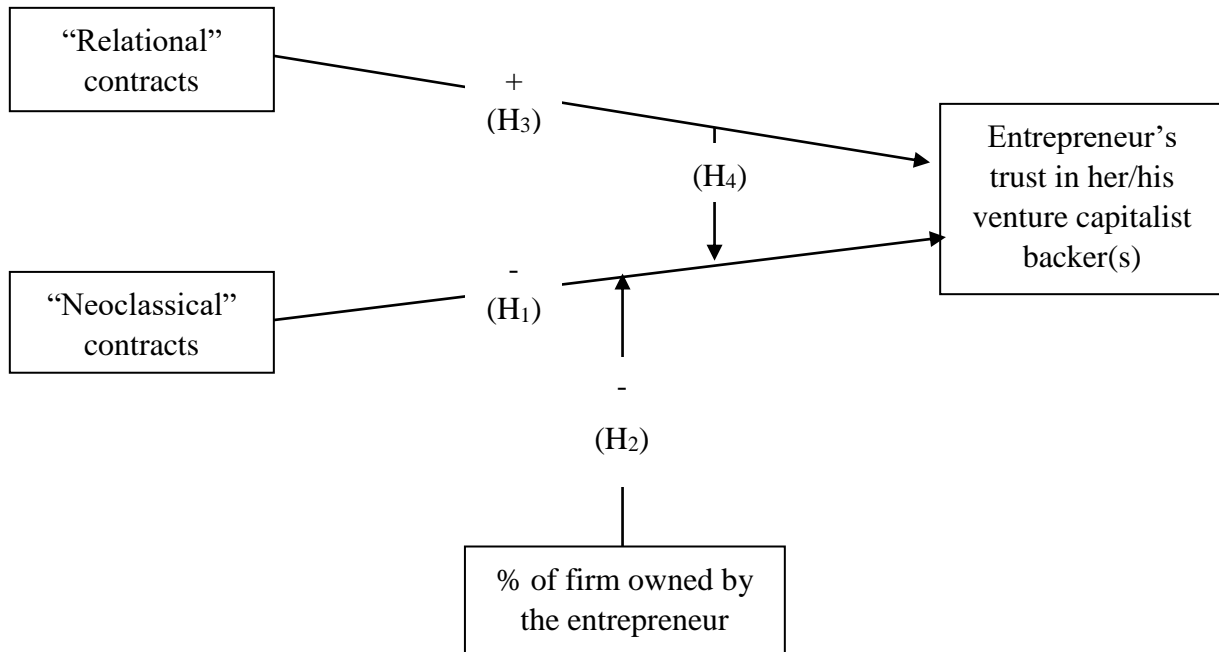


Figure 2 Interaction between neoclassical contracting and ownership stake on entrepreneurs' trust in the VC.

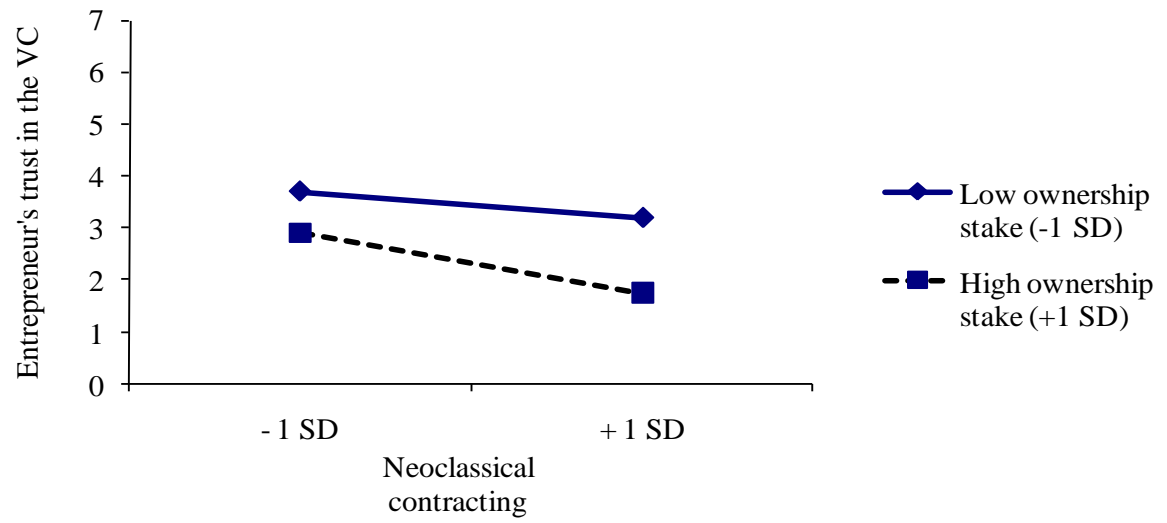


Table 1a: Factor analysis - trust scale

	<i>Trust</i>
<i>Integrity</i>	
Even when the VC gives us a rather unlikely explanation, we are confident that it is telling the truth	0.47
The VC usually keeps the promises that it makes to our firm	0.78
Whenever the VC gives us advice on our business operations, we know that it is sharing its best judgment	0.86
Our organization can count on the VC to be sincere	0.84
<i>Benevolence</i>	
Though circumstances change, we believe that the VC will be ready and willing to offer us assistance and support	0.81
When making important decisions, the VC is concerned about our welfare	0.80
In the future, we can count on the VC to consider how its decisions and actions will affect us	0.84
When it comes to things that are important to us, we can depend on the VC's support	0.78
Percentage of variance explained (total: 60.87%)	

Table 1b: Factor analysis - neoclassical contracting and relational contracting scales.

In dealing with our (main) venture capitalist:	<i>Neoclassical contracting</i>	<i>Relational contracting</i>
...our contract precisely defines the roles of each party	0.85	0.09
...our contract precisely defines the responsibilities of each party	0.82	0.14
...our contract precisely states how each party is to perform	0.79	-0.05
...our contract precisely states the legal remedies for failure to perform	0.89	-0.10
...our contract precisely states what happens in the case of events occurring that were not planned	0.75	-0.20
...we have a mutual understanding of the role of each party	-0.02	0.91
...we have a mutual understanding of the responsibilities of each party	0.05	0.96
...we have a mutual understanding of how each party is to perform	0.14	0.92
Percentage of variance explained (total: 75.71%)	42.24%	33.47%

Table 1c: Factor analysis - VC networking and VC monitoring scales.

Our (main) venture capitalist adds value to our company by:	<i>VC networking</i>	<i>VC monitoring</i>
...helping to get additional finance partners	0.81	0.10
...linking our company to potential strategic partners	0.83	0.13
...increasing our company's reputation	0.73	0.29
...being the interface with the company's investors	0.75	0.24
...monitoring our company's financial performance	0.08	0.89
...monitoring our company's operational performance	0.27	0.83
...controlling our company's costs	0.26	0.84
Percentage of variance explained (total: 70.46%)	36.87%	33.59%

Table 2: Descriptive statistics, Pearson correlations and Cronbach alpha scores

<i>Variables</i>	<i>Mean</i>	<i>SD</i>	<i>Pearson correlations and Cronbach alpha scores</i>								
			1.	2.	3.	4.	5.	6.	7.	8.	9.
1. Relationship tenure	3.81	3.55	-								
2. ICT/life sciences firms	n.a.	n.a.	-.25*	-							
3. % Ownership entrepreneur	24.94	27.26	.01	-.22*	-						
4. Firm size	156.63	293.44	.00	-.23*	-.25*	-					
5. Neoclassical contracting	4.70	1.52	-.11	-.07	.13	-.01	.88				
6. Relational contracting	5.11	1.18	-.04	.00	.07	.05	.37**	.92			
7. VC added value in monitoring	3.73	1.47	-.21	.05	.00	-.05	.26*	.45**	.85		
8. VC added value in networking	3.84	1.48	-.07	.03	-.15	.08	.04	.25*	.45**	.81	
9. Entrepreneur's trust in the VC	4.97	1.14	.12	-.29**	.14	.02	.02	.56**	.48**	.35**	.90

** p<.01; * p<.05; Cronbach alpha scores appear on the diagonal for each variable

Table 3: OLS-regression analysis of the relationship between contracting and the entrepreneur's trust in the VC

	Trust in the VC
<i>Model 1</i>	β
Intercept	**
Relationship tenure	.11
ICT/Life sciences firms	-.31**
LnFirm size	-.13
% Ownership entrepreneur	.03
Neoclassical contracting	-.22*
Relational contracting	.46**
VC added value in monitoring	.27*
VC added value in networking	.17
F statistic	11.72**
Model R ²	.60

Note: Standardized beta coefficients are depicted.

** p <.01, * p <.05.

Table 4: OLS moderated regression analysis of the relationship between contracting and the entrepreneur's trust in the VC

	Trust in the VC		
<i>Model 2</i>	β		
Intercept	**		
Relationship tenure	.10		
ICT/Life sciences firms	-.33**		
LnFirm size	-.15		
% Ownership entrepreneur	-.04		
Neoclassical contracting	-.24**		
Relational contracting	.53**		
VC added value in monitoring	.26*		
VC added value in networking	.15		
% Ownership entrepreneur x Neoclassical contracting	-.18*	ΔF	4.40*
		ΔR^2	0.03
F statistic	11.50**		
Model R^2	.63		
<i>Model 3</i>			
Intercept	**		
Relationship tenure	.11		
ICT/Life sciences firms	-.31**		
LnFirm size	-.12		
% Ownership entrepreneur	.01		
Neoclassical contracting	-.19*		
Relational contracting	.45**		
VC added value in monitoring	.27*		
VC added value in networking	.16		
Relational contracting x Neoclassical contracting	.08	ΔF	.78
		ΔR^2	0.00
F statistic	10.47**		
Model R^2	.60		

Note: Standardized beta coefficients are depicted.

** $p < .01$, * $p < .05$.

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